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The removal of a specialist oversight body for local public audit: Insights from the health service in England

ABSTRACT

The abolition of the Audit Commission in England and Wales removes the ‘protector of the public purse’. The oversight body and its audit practice are largely replaced by the private sector regime and audit firms. We analyse the audit market for health service foundation trusts, an area of local public audit that operates without oversight from the Commission. We find evidence of premiums paid to some Big4 firms and that the presence of specialist public service auditors results in fee discounts. The firms limit their liability and assurance of audit quality is reduced under new audit regimes and governance structures.

Key words: Audit oversight bodies, specialist auditors, premium audit fees, audit quality, audit independence, governance, foundation trusts.

The removal of a specialist oversight body for local public audit: Insights from the health service in England

1 Introduction

We explore the implications of the removal of the Audit Commission in England and Wales. For decades, the Audit Commission (website logo - ‘protecting the public purse’) was responsible for appointing auditors from its own specialist audit service and those of approved audit firms for local government and National Health Service (NHS) bodies. In 2012, the Commission was responsible for the audit appointments to 353 local authorities, 263 health bodies, 76 police authorities, 82 other bodies and 10,000 small bodies such as parish councils (Audit Commission, 2013). The Commission set fee scales; determined the audit work (the Audit Code) including performance audits, and monitored the quality of the audit work.

In 2010, the government announced the abolition of the Audit Commission. The Secretary of State for Communities and Local Government claimed -

"The Audit Commission has lost its way. Rather than being a watchdog that champions taxpayers' interests, it has become the creature of the Whitehall state.

"We need to redress this balance. Audit should remain to ensure taxpayers' money is properly spent, but this can be done in a competitive environment, drawing on professional audit expertise across the country.

"These proposed changes go hand in hand with plans to create an army of armchair auditors –local people able to hold local bodies to account for the way their tax pounds are spent and what that money is delivering."

BBC, August 2010.

The dismantling of the Audit Commission commenced. In 2010 the Commission ceased to assess the performance of local public bodies. In 2012 the Commission's audit practice work transferred to private sector firms and it was proposed that all local public bodies in England appoint their own auditors and the regulation of local public audit transfer to the Financial Reporting Council (DCLG 2012). Alongside the dismantling of the Commission, an army of armchair auditors would hold local organizations to account by examining their detailed transactions that would be made available through websitesⁱ (DCLG 2011).

We investigate the likely impact of the dismantling of the Commission. The introduction of NHS Foundation Trusts from 2004 had provided an area of local public audit that was outside the oversight of the Audit Commission. Foundation Trusts (FTs), unlike NHS trusts, had the ability from their inception, to appoint their own auditors, they were not subject to audit fee scales, definition of their work or monitoring by the Commission. An analysis of the audit arrangements and fees in FTs in recent years therefore provides some insights into how local public audit in other parts of the public sector may fare in terms of price and quality after the abolition of the Audit Commission.

In the next section we consider audit quality and oversight bodies as applied in a public sector context. We then present the audit arrangements for both NHS trusts (with Audit Commission oversight) and Foundation Trusts (without Audit Commission oversight) and develop our hypotheses on audit pricing. Based on private sector literature of audit fees and earlier studies in NHS trusts we produce a departure model for FT audit fees related to size, complexity, location and risk. We derive hypotheses on audit fees in relation to different types of auditor for testing to explore whether the removal of the Audit Commission changes prior findings in the NHS trust audit market. This design is outlined in section five and our results are set out in section six, followed by discussion and conclusions.

2 External audit quality and oversight bodies

In recent years, oversight bodies have sought to enhance external audit quality. External audits of financial statements are mandated because the ownership and management of organisations have become increasingly separated (Porter et al, 2008). The financial statements form the basis of the account, and the independent review and report on those statements by the external auditor improves the credibility of the account and hence accountability. Porter et al (2008) claim the benefits are reflected in the fundamental principle of auditing:

‘Auditors add to the reliability and quality of financial reporting [to external parties]; they provide to directors and officers [of the auditee] constructive observations arising from the audit process; and thereby contribute to the effective operation of business capital markets and the public sector.’

Auditing Practices Board, 2008, Appendix 2

Under democratic government, accountability for public money and the role of the auditor is increased (Chan, 2003). This wider audit role is explained by Stewart (1984) and Sharman (2001): the public sector auditor, in addition to the need to attest to the ‘true and fair view’ of the financial statements, must ensure regularity, propriety and value for money. Auditors are required to publish public interest reports when they feel it necessary to bring to the attention of the audited body and the public any significant matter arising in the course of an auditⁱⁱ.

The independence of an external audit body is integral to its quality in the accountability process (Hollingsworth et al, 1998) and is emphasised in auditing texts.

‘The significance of independence in the work of the independent auditor is so well established that little justification is needed to establish this concept as one of the cornerstones in any structure of auditing theory.’

Mautz and Sharaf (1961) *The Philosophy of Auditing*.

Independence refers both to independence from the audited body and to having an independent (objective) state of mind (DeAngelo, 1981; Mautz and Sharaf, 1961). Independence is ‘widely thought to be necessary for the quality of audits’ (Jamal and Sunder, 2011:284). Lord Sharman’s review of audit arrangements in the UK made it clear

that to safeguard independence public sector organisations should not be able to appoint their own auditorsⁱⁱⁱ:

‘auditors must be independent to avoid improper influence and allow work to be carried out freely. Independence is considered to encompass the methods of appointment of auditors, the financial relationship between auditor and auditees, discretion in the amount of work necessary, the ability to follow up the implementation of recommendations, and the ability to have access to information in the custody of the audited body necessary for the work.’

Paragraph 3.39 Sharman (2001)

The quality of the audit is also dependent on the knowledge and expertise of the auditor. The audit of public sector organisations is frequently the exclusive domain of specialist auditors^{iv}, but in England, private firms have undertaken some local public audits since 1972. Specialist public sector auditors could arguably have enhanced knowledge and expertise. However, there is a substantial body of empirical evidence in the private sector, particularly in the United States, that is consistent with the largest accounting firms providing higher quality audits: the largest accounting firms were named defendants in lawsuits proportionately less than other auditors (Fuerman, 2000); and the largest accounting firms are sued at a lower frequency per estimated audit performed than other auditors (Palmrose, 1988). Thus, it has long been argued that larger accounting firms supply a higher level of audit quality and hence lend greater credibility to the audited financial statements than smaller firms (Dopuch and Suminic, 1980 and 1982; DeAngelo, 1981). A common rationale for this proposition is the depth of the auditors’ pocket. The deep pockets hypothesis (Wallace, 1980), states that large accounting firms have more incentives to issue accurate reports because they have greater wealth at risk from litigation. Thus the quality aspect of specialist knowledge of public sector auditors may be countered by the quality engendered by the deep pockets of large private firms.

Audit oversight bodies seek to increase the quality of the audit by ensuring greater independence of the auditor from the audit client and monitoring their work (Malsch and Gendron, 2011). Audit oversight of UK local government was introduced through the setting up of the Audit Commission in England and Wales in 1983. In 1991, the Audit Commission extended its role to NHS trusts. The Audit Commission also had its own audit practice (District Audit^v), the Commission assigned the audit of local authorities and NHS trusts to its audit practice and accredited private sector audit firms; typically private firms undertook 30% of local authority and NHS trust audits under the oversight of the Audit Commission. Thus, auditors were appointed by the Commission, not the organisation (the auditee). The fees and the quality of the work were set and monitored by the Commission. The Commission has also been seen as an agent of central government in ensuring improved public service performance (Walker et al, 2011), but assessment and inspection work led to it being viewed as a ‘creature of the Whitehall State’ by the Secretary of State (BBC, August 13th 2010) and this work ceased in 2010..

In the commercial world, audit oversight boards are a recent innovation. Following the collapse of Enron (and their auditors Arthur Andersen) in 2001, the independence of audit firms from their auditees and the quality of their audit work was the subject of intense debate and scrutiny (Malsch and Gendron, 2011). As a result, the Sarbanes-Oxley Act became US federal law in 2002 under which the Public Company Accounting Oversight Board (PCAOB), a private-sector non-profit corporation, was created. The stated purpose of the Act was to "protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports". The PCAOB under Section 101 of the Sarbanes-Oxley Act has substantial powers, including the power to register public accounting firms that prepare audit reports for issuers and set auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports. Part of the PCAOB's power to set rules of the auditing industry includes the power to regulate the non-audit services that audit firms may offer their audit clients (such as consulting or tax services). In cases such as Enron and Worldcom, auditors' independence from their clients' managers had been compromised because of the large fees that audit firms earned from these non-audit services.

In the UK, the Conduct Committee (previously the Professional Oversight Board) of the Financial Reporting Council (FRC) provides independent oversight of the regulation of the auditing profession. The Committee through its Audit Quality Review (AQR) team, formerly the Audit Inspection Unit monitors the quality of the audits of listed and other major public interest entities under the 2006 Companies Act^{vi}. From 1st April 2013 the review of policies and procedures of those firms with ten or fewer 'major' audit clients will be delegated in full to the professional bodies with which the firms are registered for audit purposes such as the ICAEW. The FRC also produces corporate governance codes that rely on investors to ensure company adherence.

Internationally, there is a growing body of evidence that client retention incentives and accountability pressures threaten audit independence and that an oversight board enhances independence (Koch et al, forthcoming). The European Commission's 2010 Green Paper on 'Audit Policy: Lessons from the crisis' recommends third party oversight of audits (Humphrey et al, 2011). Despite this background of increasing interest in audit oversight bodies, the Secretary of State made his decision, to abolish the Audit Commission –the Commission's audit practice would be outsourced for the audit of the 2012/13 accounts. The Audit Commission, significantly smaller, would remain in place for a few years to oversee contracts for local public services in England. The central top down approach of holding local public bodies to account would be replaced by providing detailed information such as payments over £500 and senior employee salaries to an 'army of armchair auditors' (local residents and taxpayers). Our study in health service foundation trusts explores the quality (independence, specialist expertise) and price implications of the removal of an oversight body for local public audit.

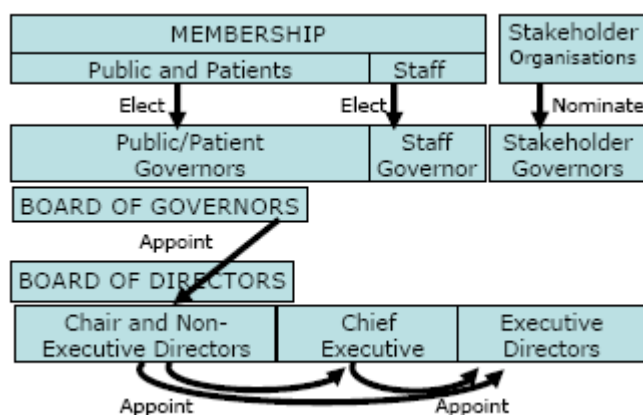
3 External audit in the National Health Service

In the NHS in England, the provision of hospital services is provided by NHS Trusts and Foundation Trusts. Since 2004, NHS Trusts have been able to apply for Foundation Trust (FT) status. It is intended that all NHS trusts will become FTs.

NHS trusts are accountable via health authorities to the Department of Health. The Audit Commission appointed the auditors from its in-house auditors or private firms, set audit fee scales, monitored audit quality and assessed VFM and performance (Audit Commission 2010a). Private sector auditors were invited to tender for the audits by the Audit Commission and were only appointed if they could show they had the necessary capacity and capabilities (Audit Commission, 1998). The scale of audit fees for individual NHS bodies comprised: a fixed element, for different types of audited bodies; an element related to gross expenditure and a regional premium for audits in London and the South East of England. Fees could be above or below the scale when the Audit Commission considered that substantially more or less work was required than envisaged by the scale fee. However, the Audit Commission did not expect to vary the scale fee by more than 30 per cent, upwards or downwards. The quality of the audit work of appointed auditors was reviewed by the Audit Commission. The annual quality review programme included quarterly reviews of compliance with regulatory requirements and the Code; annual sampling of work on audit of financial statements, use of resources and value for money (VFM), written audit reports and certification (Audit Commission, 2010b). The Audit Commission promoted good practice and provided a forum for discussion and guidance on technical issues.

However, FTs have greater independence than NHS trusts and they are directly accountable to Parliament. Monitor, the independent regulator of foundation trusts, provides a recommended governance code for FTs. The governance structure of a typical FT is shown in Figure 1.

Figure 1: The Governance Structure of a Foundation Trust



The membership is drawn from the local community (the public, patients and staff). The membership and the stakeholder organisations, such as universities or city councils, nominate and elect governors. The board of governors appoints the chair and non-executive directors (NEDs). They in turn appoint the chief executive who together with the chair and

NEDs appoints the executive directors. In a FT, governors replace shareholders, it is the governors who appoint the auditors on advice from the audit committee and it is to the governors that the auditors address their report.

There have been several studies examining the audit arrangements of NHS Trusts under the oversight of the Audit Commission (Clatworthy et al, 2000, 2002, 2008; Basioudis and Ellwood, 2005a, 2005b; Ballentine et al, 2008), but none on audit in FTs. Table 1 shows the changes in the NHS Trust audit market observed from these studies.

Table 1. The Observed Audit Market for NHS Trusts

	2000*		2004**		2005***	
	N	%	N	%	N	%
Big4 firms	106	28.42%	74	28.24%	52	31.14%
2 nd tier firms	20	5.36%	23	8.78%	17	10.18%
Total private firms	126	33.78%	97	37.02%	69	41.32%
Audit Commission	247	66.22%	165	62.98%	98	58.68%
Total	373	100%	262	100%	167	100%
*Basioudis and Ellwood (2005a), **Clatworthy et al (2008), ***Ballantine et al (2008), for a sample of acute NHS Trusts						

The proportion of audit work undertaken by the Audit Commission's audit practice declined between 2000 and 2005. Big4 firms increased their percentage of audits (31% in 2005) with second tier firms almost doubling their percentage of audits between 2000 and 2005 to over 10%. Nonetheless, the Audit Commission retained the majority of the work.

However, FTs since their inception in 2004 have operated under a different audit regime from NHS Trusts. FT boards of directors have more autonomy to make financial and strategic decisions and have a framework of local accountability through members and a board of governors, which has replaced central control from the Secretary of State for Health (Figure 1). FT audit committees make recommendations to the board of governors in relation to the appointment, re-appointment and removal of the external auditor and approve the remuneration and terms of engagement of the external auditor. Contrary to the principle established in Sharman, FTs can choose their auditor from any auditor in the market that complies with Monitor's requirement in terms of expertise and standing (including prior to 2012, the audit practice of the Audit Commission).

Monitor's regulatory role for FTs does not include the duties provided by the Audit Commission for NHS Trusts. It provides guidance, a Code of Governance and an Audit Code, and delegates limited audit monitoring to the Quality Assurance Directorate of the Institute of Chartered Accountants in England and Wales to review the audit work (a similar approach to that adopted by the FRC for private sector audit firms with ten or fewer 'major' audit clients). For FTs, the Audit Commission, through its audit practice, is just another provider of audit services.

Thus, the NHS provides an appropriate setting for the study of how the presence of an oversight body may affect audit price and quality. We have segregation of auditors undertaking similar work under different scenarios. One scenario covers NHS Trusts where an oversight body (the Audit Commission) appointed the auditor from its specialist auditors or accredited firms, controlled fees and scrutinised their work, this scenario has been examined in previous studies. A second scenario is studied in this paper, where FTs appoint their own auditor and there is no specialist audit oversight body. This is therefore similar to the future situation envisaged for all local public audit except for the presence of a specialist public sector auditor in the FT audit market from 2004-2012.

4. Determinants of audit fees in the NHS and hypotheses development

Previous NHS audit studies have examined the NHS trust scenario. There are no published studies on either audit quality or audit fees in FTs. A study of audit fees in the FT sector will enable greater understanding of what may arise following the closure of the Audit Commission's audit practice in 2012 and the later abolition of the remainder of the Audit Commission. The audit context of FTs has many similarities to the proposed private sector model, there is no audit oversight body, merely quality monitoring by the professional body and FTs are able to choose their own auditor. The main difference between the FT context prior to 2013 and the private context is the presence of a specialist public sector auditor (the audit practice of the Audit Commission). We develop our hypotheses in the next section with reference to audit fee literature in the NHS and other public and private sector contexts.

4.1 Influence of size, location, risk and complexity

Numerous studies have examined the determinants of audit fees both in the public and private sectors. According to these studies, audit fees are usually determined by size, location, complexity and risk, both in the private and the public sector. The meta-analysis conducted by Hay et al (2006) finds that size measures are overwhelmingly positive and significant in explaining audit fees both in the public and the private sector. In the UK, studies by Basioudis (2002), McMeeking et al (2006) and Clatworthy and Peel (2007) confirm similar findings. This is easily explicable as audit fees are usually based on billable hours and larger organisations are likely to require more auditor work in order to express an opinion on the financial statements. Size is typically measured by total assets, with some studies using revenues (Hays et al, 2006). In the NHS trust context, where the Audit Commission sets limits for audit fees, studies (Basioudis and Ellwood, 2005a; 2005b; Ballantine et al, 2008)) find that the size of the NHS trust positively impacts on audit fees. In this context, size is usually measured using revenues and/or total assets. The recent results of Xue and O'Sullivan (2013) also show that size is the main determinant of audit fees in the UK University context.

The location of the auditee also affects audit fees. Cullinan (2002) posits that a city's cost of living is likely to be related to an accounting firm's billing rates. In some countries, there is

one metropolitan centre where costs are higher than in the rest of the country, as is the case in the UK (London). Of the 10 studies included in the meta-analysis conducted by Hay et al (2006) that specifically consider the London location of an audit client, 8 show a significant and positive coefficient. In the UK, Basioudis (2002) finds that audit production costs are associated with the geographical location of the client. Chan et al (1993) and Ezzamel et al. (1996) also find that audit firms charge higher fees not only for the London area but when they or their auditors are located in the South East of England. Beattie et al (2001), in their study of audit fees in the British voluntary sector, also include a variable for the London location of the organisations and find similar results. As presented in Section 3, the Audit Commission used higher fee scales for London and the South East region when determining audit fees. Basioudis and Ellwood (2005b) include 'London' as a variable in their study of audit fees which, as expected, is found positive and significantly related to statutory audit fees. However, the London premium exists when the audit practice is the Audit Commission, but disappears when the auditor is a private firm. Clatworthy et al (2002) note the influence of two NHS trust locations, London and the South East of England, and find that higher fees are paid in these areas in relation to the rest of England.

Audit risk is another determinant of audit fees. Audit risk is associated with the probability of an auditors failure to detect significant errors and misstatements in the financial accounts which could expose auditors to liability claims and/or reputational loss. Therefore, in the presence of risk, auditors will include some premium, due to increased audit hours and audit testing or as an insurance premium (Chan et al, 1993). Some studies find a positive and significant association in the UK private sector (McMeeking et al 2006 and Clatworthy and Peel 2007). Hay et al (2006) confirm the results in their meta-analysis. In their empirical analysis of audit fees in NHS trusts, Basioudis and Ellwood (2005a and 2005b) find risk, when captured by whether the trust has incurred net losses or not, significant and positive in their 2005b study based on total auditor remuneration, but significant and negative in their 2005a study on the regulatory audit fee. Thus a loss-making trust may incur further payments to the auditor on non-regulatory work.

Hay et al (2006, p169) claim research studies "leave little doubt that the relationship between fees and complexity is positive and significant." The more complex a client, the harder and more time-consuming the audit is likely to be. However, complexity is measured in many different ways (Hay et al 2006; Beattie et al 2001). The studies in NHS trusts use measures specific to the context, Basioudis and Ellwood (2005a, 2005b), similar to Clatworthy et al (2002), use two measures to capture complexity: 1) whether the trust belongs to the General Acute activity or a Multi-service activity group, because more complex organisations require more effort to audit than their less diverse counterparts; and 2) the ratio of inventory to total assets, because inventory levels have traditionally impacted significantly on audit workload and hence audit fees. Basioudis and Ellwood find that the type of trust is significant and positively influences audit fees but that the ratio of inventory to total assets does not.

Clatworthy et al (2008) compare audit fees between NHS trusts and a size-matched sample of similar organisations in the private sector, and find significant differences in audit fees (higher in NHS trusts) and non-audit fees (lower in NHS trusts). In addition, they find that during the period 1997-2004 there was a reduction in non-audit fees. This may reflect the reluctance of the Audit Commission to approve any non-audit work since 2001.

4.2 Big4 premium

The meta analysis conducted by Hay et al (2006) strongly supports big firms having higher audit fees. However, with the exception of Price Waterhouse in the 1980s, no individual large firm exhibited a fee premium. More recent studies also find a big firm premium. McMeeking et al (2006) report a big six premium for a sample of UK quoted firms over the period 1985–1995. Clatworthy and Peel (2007) find that Big4 firms and the next four largest mid-tier auditors have higher fees than their smaller counterparts. Hogan and Wilkins (2008), in an analysis of auditors' responses to control risk, find that audit fees are significantly higher for companies with internal control deficiencies and that the incremental fee for clients of Big4 auditors is significantly higher than the incremental fee for clients of non–Big4 auditors. Nonetheless, the results of Griffin et al (2009) do not find that Big4 firms charge a premium in the New Zealand private sector context.

The results of Basioudis and Ellwood (2005a; 2005b) support the existence of differential pricing of audit fees in NHS trusts, but only on part of the auditor remuneration related to regularity audit fee. For auditors' total remuneration (controlled by the Audit Commission), the authors found no premiums. The studies of Clatworthy et al (2000, 2002) within the NHS trust context, found that Big4 firms did not charge premiums. On the whole, the studies show the Audit Commission oversight to be effective in preventing premium payments to auditors, a measure that safeguards auditor independence (alongside the external appointments process, and auditor rotation).

4.3 Hypotheses

The hypotheses are designed to identify the implications of no specialist audit oversight body. Based on previous research into NHS trusts and private sector audit markets, we identify hypotheses to investigate the audit arrangements in FTs. We aim to determine whether private audit firms charge audit fees on the same basis as the Audit Commission, i.e. the variables that determine the fees charged by private audit firms for FT audits. We also seek to identify whether private firms are more expensive than specialist public sector auditors i.e. the audit practice of the Audit Commission. We then investigate how the type of firm and individual Big 4 firms compare with the fees charged by the Audit Commission's audit practice. The hypotheses we test are:

H1: The influence of size, location, complexity and risk impacts differently on audit fees when the audit practice is the Audit Commission rather than a private audit firm.

H2: Being audited by a private firm results in higher audit fees than being audited by the Audit Commission's audit practice.

H3: Being audited by a Big4 firm results in higher audit fees than being audited by the Audit Commission's audit practice.

H4a: Being audited by PwC results in higher audit fees than being audited by the Audit Commission's audit practice.

H4b: Being audited by KPMG results in higher audit fees than being audited by the Audit Commission's audit practice.

H4c: Being audited by Deloitte results in higher audit fees than being audited by the Audit Commission's audit practice.

H4d: Being audited by a second tier firm does *not* result in higher audit fees than being audited by the Audit Commission's audit practice.

5 Data and research design

We use data from the Annual Report and Accounts for 2009/10 for all the 117 FTs that held foundation trust status at 1st April 2009. The FTs comprise 70 acute hospitals; 13 specialist hospitals and 34 mental health hospitals.

Table 2 shows the distribution of the audit market and audit fees of the 117 FTs included in our analysis. In contrast with studies presented in Table 1 private firms hold 62% of FT audits compared with only 41% in the NHS trust sector in 2005; Big 4 firms hold 55% but second tier firms hold only 7% (compared with over 10% in NHS trusts in 2005).

Table 2. Distribution of auditors and audit fees in Foundation Trusts for the year 2009-10

	Audits			Audit fee* £000s		
	N	%	Mean	Std. Dev	Min	Max
PwC	28	23.93	75.29	35.48	40.00	210.00
KPMG	26	22.22	65.00	20.05	37.00	110.00
Deloitte	10	8.55	93.00	44.90	51.00	172.00
Big4 firms**	64	54.70	73.88	32.83	37.00	210.00
2nd tier firms	8	6.84	68.00	12.74	53.00	93.00
Total private	72	61.54	73.22	31.25	37.00	210.00
Audit Commission	45	38.46	66.04	17.24	45.00	121.00
Total	117	100	70.46	26.88	37.00	210.00
<i>Notes:</i>						
<i>*Excludes the audit costs of IFRS implementation if this information is stated in the financial statements.</i>						
<i>**The other Big4 firm, Ernst & Young had no NHS audits.</i>						

Ellwood and Garcia-Lacalle (2012) provide an analysis of FT auditors by age of FT. They find that as FTs mature the dominance of private firms, and in particular, the dominance of Big4 firms is more pronounced. Thus for FTs that have held foundation status for more than three years, private firms have 75% of the audits with Big4 firms holding 61% and second tier firms only 5%.

To test our hypotheses, we use OLS regression models with regulatory audit fees as the dependent variable. In contrast to other studies that analyse both regulatory audit fees and total auditor remuneration, we focus our analysis on the first one because regulatory work represents homogeneous audit work for auditors, whereas other auditor remuneration may not. As independent variables, we include the control variables previously described as significant in explaining audit fees (size, location, risk and complexity) and variables that capture the auditor. We first create a ‘departure’ model that only includes the control variables to determine how these characteristics affect audit fees. Table 3 presents the control variables included in our models.

In our model, size is represented using total assets (long term assets plus current assets). Within the NHS trust literature, Clatworthy et al (2002) use trust total revenue, but include trusts total assets as another measure of the auditee size. Ballantine et al (2008) use total assets as the measure of size. Clatworthy et al (2008) argue that revenue is a better proxy for size because the value of fixed assets may be understated. Prior to the adoption of International Financial Reporting Standards (IFRS) in 2009, the value of fixed assets excluded any assets provided through the Private Finance Initiative (PFI) since these remained ‘off balance sheet’. The financial statements for the financial year 2009/10 are under IFRS and hence we use total assets to represent the size of the FTs. Location is represented by a dummy variable that takes value ‘1’ if the FT is located in London or in the South East of England, according to the regional classification used by Monitor and the Audit Commission. Risk is captured by a dummy variable that takes ‘1’ if the FT incurs a deficit during the financial year and ‘0’ if it has obtained a surplus. Complexity is a dummy variable that takes ‘1’ if the FT is classified by the NHS as an acute hospital, and ‘0’ if it is classified as either a specialist or a mental health hospital, because these hospitals perform a limited range of medical treatments.

Table 3. Main descriptive figures of control variables for the 117 NHS FTs

		Mean	Std dev	Min	Max
Size	Total Assets (£000)	186,965	145,955	9,427	1,046,814
Location	<i>27 FTs in London & South East (SE) of England</i>				
Risk	<i>57 FTs incurring a deficit</i>				
Complexity	<i>70 acute, 13 specialist & 34 mental health</i>				

To test *H1*, prior to the introduction to the experimental variables, we conduct OLS regressions splitting the sample of our departure model into two sub-samples: a first sub-

sample that only includes FTs audited by the Audit Commission's audit practice and a second sub-sample with those FTs that are audited by private firms (Big4 and second tier). Our objective when splitting the sample in this way is to determine whether audit fees are determined in a similar way by the Audit Commission and private firms.

Experimental variables are incorporated into our 'departure' model to test the further hypotheses. Auditors are classified into five categories: the Audit Commission, private firms, Big4 firms, non-Big4 firms and second tier audit firms, as well as individual categorical variables for specific Big4 firms: PricewaterhouseCoopers (PwC), KPMG and Deloitte (DE). In order to test our hypotheses related to whether private firms, in particular Big4 firms, and individual Big4 audit firms are able to charge a premium, we introduce into the departure model one more variable. To test whether private firms charge a premium over the Commission, hypothesis H2, we introduce a dummy variable (PRIV) which takes '1' if the auditor is a private firm and '0' if the auditor is the Audit Commission. Similarly, to test H3, we introduce into the departure model a dummy variable (BIG4) which takes '1' when the auditor is a Big4 firm and '0' if the auditor is the Audit Commission. To test H4a to H4d hypotheses, we introduce into the departure model a dummy variable (PwC for H4a, KPMG for H4b, DE for H4c and second tier for H4d) which takes '1' if the auditor is that represented by its name and '0' if the auditor is the Audit Commission. When testing H3 and H4, only those FTs that meet the condition of being audited by the auditors under consideration are included, which reduces the size of the sample.

6 Analysis of results

Our results enable us to indicate the impact of removing an oversight body.

Table 4. Determinants of audit fees for FTs: District Audit and private firms						
	Departure model		Model 1a (AC)		Model 1b (private)	
	Std Beta	Signif.	Std Beta	Signif.	Std Beta	Signif.
Size	0.531***	0.000	0.200	0.211	0.608***	0.000
Location	0.225***	0.006	0.477***	0.002	0.176*	0.068
Risk	0.099	0.204	0.023	0.872	0.203**	0.035
Complexity	-0.122	0.157	-0.086	0.576	-0.140	0.178
	N=117		N=45		N=72	
R²	0.368		0.320		0.449	
Adj R²	0.345		0.252		0.416	
F	16.279***		4.712***		13.657***	

*Significant at 0.1, ** Significant at 0.05, ***Significant at 0.01

Our departure model (Table 4) shows that of those characteristics that traditionally have been reported as influencing audit fees (size, location, risk and complexity) only size and location are positive and significant for FTs. Thus a different fee structure is likely to occur

with no Audit Commission oversight. Table 4 also shows the result of the ‘departure’ model when the sample is split to consider the type of auditor: Audit Commission (model 1a), and private firms (model 1b), in order to test our first hypothesis. When the regression is carried out considering those FTs audited by the Audit Commission only location is found positive and significant. When the regression is carried out considering FTs audited by private firms three factors are found significant and positive: size, location and risk. Moreover, the ability of the model (R^2) to explain the dependent variable, that is, audit fees, rises from 0.320 for model 1a to 0.449 for model 1b. This supports our hypothesis H1, that is, private firms have different considerations from the Audit Commission when determining their fees.

The inclusion of the PRIV variable (‘1’ if the auditor is a private firm and ‘0’ if it is the Audit Commission) in model 2, to test H2, shows that, in addition to size and location, being audited by a private firm results in significantly higher fees than those audited by the Audit Commission (see Table 5). This effect is more evident when the variable included is BIG4, to test H3, whether the Big4 firms charge a premium to their auditees in relation to the Audit Commission (Table 5). In this case, the value of the coefficient (std beta) and the significance of the variable BIG4 and the R^2 (0.409) of the model are higher than in model 2, which includes the variable PRIV.

In model 3 (Big4 firms), risk becomes more important (though only significant at the 0.1 level). These results support our hypothesis H2 and H3, that is, private firms, and in particular Big4 firms, charge higher fees than the Audit Commission.

Table 5 Comparison of audit fees of private firms and the Audit Commission’s audit practice												
	Model 2		Model 3		Model 4a		Model 4b		Model 4c		Model 4d	
	Std Beta	Sig.	Std Beta	Sig.	Std Beta	Sig.	Std Beta	Sig.	Std Beta	Sig.	Std Beta	Sig.
Size	0.527***	0.000	0.517***	0.000	0.452***	0.000	0.279**	0.048	0.441***	0.001	0.178	0.235
Location	0.225***	0.005	0.246***	0.004	0.334***	0.002	0.324***	0.010	0.236*	0.064	0.442***	0.002
Risk	0.129	0.103	0.146*	0.079	0.064	0.545	0.173	0.163	0.053	0.635	0.032	0.816
Complex	-0.130	0.126	-0.110	0.216	-0.079	0.482	-0.055	0.679	-0.169	0.172	-0.094	0.511
PRIV	0.151**	0.048										
BIG4			0.164**	0.038								
PwC					0.172*	0.092						
KPMG							0.072	0.521				
DE									0.272**	0.017		
2ndtier											0.018	0.892
	N=117		N=109		N=73		N=71		N=55		N=53	
R²	0.390		0.409		0.391		0.236		0.453		0.265	
Adj R²	0.362		0.380		0.345		0.177		0.397		0.187	
F	14.177***		14.237***		8.598***		4.019***		8.104***		3.387**	

* Significant at 0.1, **Significant at 0.05, *** Significant at 0.01

Models 4 (also Table 5) show that PricewaterhouseCoopers (model 4a), but especially Deloitte (model 4c), are able to charge premiums fees when compared to the Audit Commission, as their coefficients are positive and significant. Therefore, hypotheses H4a and H4c are supported. Neither KPMG (model 4b) nor second tier firms (model 4d) charge

premiums to their auditees. Therefore, H4b is rejected whereas H4d is supported. In these models, the size and location variables are positive and significant, except for the model 4d, second tier firms, in which only location is significant.

7 Discussion and conclusions

The results provide insights into how local public audit in England may develop without the Audit Commission. Established in the 1982 Local Government Finance Act, the Audit Commission appointed auditors from private firms and from its audit practice to local public bodies, it controlled audit fees, determined the scope of audits and monitored audit quality. In recent years it had also assessed the performance of local authorities and NHS trusts according to national criteria. However, since 2004, the introduction of FTs in the NHS in England provided an area of local public audit not overseen by the Commission but where the Commission's audit practice continued to provide a regulatory audit service. The Audit Commission recovered its costs largely through its audit fees. Comparative price and quality analysis of the audit fees within the FT audit market and the audit arrangements across the NHS (with and without Audit Commission oversight) enables consideration of the impact of the removal of the Audit Commission to be explored.

In relation to price, we find that size and location are the only significant factors influencing FT audit fees prior to drilling down to analyse the fees by the type of auditor. Private firms, however, consider risk as also important when determining fees. In the NHS trust audit market, the Audit Commission provided an indemnity for auditors' work, in the FT sector no such indemnity applies. When the Audit Commission is removed from the equation, risk features in audit fee pricing.

Our findings support the hypothesis that being audited by a private firm, results in higher audit fees than being audited by the Audit Commission's audit practice. Specialist public sector auditors are less expensive than private auditors. We also find support for a Big4 premium i.e. Big4 firms have higher fees than other auditors. However, when examining the fees of individual Big4 firms we find evidence that Deloitte charges premium fees (and also, at a 10% level of significance, PwC), but no premium is apparent for KPMG. On the other hand, being audited by a second tier firm does not appear to give rise to premiums compared with the Audit Commission's audit practice. Unlike in the NHS trust sector where studies have shown (Clatworthy et al, 2000 and 2002; Basioudis and Ellwood, 2005b) that, on the whole, the Audit Commission's control of audit fees prevented premium payments, premiums are evident when Audit Commission oversight is removed. A higher proportion of other auditor remuneration to total auditor remuneration was also evident: 36% in FTs compared with 23% in NHS trusts^{vii}. This indicates the Audit Commission was more effective in maintaining auditor independence through restricting non audit fees. Furthermore, the presence of a specialist auditor provides a benchmark that reduces audit fees.

As discussed in Section 2, higher audit fees charged by large audit firms may be indicative of audit quality. The common argument put forward for this higher quality is the ‘deep pockets’ of the large firms that places them more at risk from litigation. However, we found evidence that Big4 firms restrict their liability when auditing FTs. Most FTs audited by Big4 firms disclose a limitation of the responsibilities of the auditor (mainly between £0.5 and £1 million).

For example:

‘The engagement letter signed on 31 March 2010 states that the liability of KPMG, its members, partners and staff (whether in contract, negligence or otherwise) in respect of services provided in connection with or arising out of the audit shall in no circumstances exceed £1million in the aggregate in respect of all such services.’

(Cambridge University Hospitals FT, Annual Report and Accounts 2009/10, Disclosure Note 3.)

In the FT sector, Big4 premium fees are not indicative of higher quality audits because of deep pockets –the pockets are stitched. In the NHS trust sector, the audit work was set and monitored by the Audit Commission. Monitor, the regulator for FTs, asked the Quality Assurance Directorate of the ICAEW to review the audit work in FTs (a system similar to proposals for all local public audit in future), the 2008/09 review found an audit by the Audit Commission’s audit practice to be unprecedented in having no improvement points (Audit Commission, 2010b). This suggests that specialist auditors provide exemplary quality.

Audit quality is strongly related to independence (De Angelo, 1981). In the NHS trust sector (as in most areas of local public audit in England), the Audit Commission appointed the auditors and therefore increased the independence of the auditor from management. The governors of Foundation Trusts appoint the auditors on advice from the Audit Committee. This reduces the independence of the auditor. In the private sector, adherence to stewardship codes is often dependent on the shareholders to enforce.

However, whilst the governors (see Figure 1 earlier) may be in a similar role to shareholders in appointing the directors, they do not have the same ownership interest. It is the government (Department of Health) that holds the dividend capital on which FTs are founded; the government that receives the dividends and, via commissioning bodies, provides finance for local services. Thus, there is also a need for auditors to report in the interests of the general tax payer and their representatives. Substituting a private sector (shareholder model), does not provide this important second level of agency accountability –the protection of the public purse.

There are incentives for management to manipulate financial statements For example, FTs pay a dividend (3.5%) to the Department of Health based on the value of their net assets. If a FT impairs its assets it has a lower asset value and pays less cash to the government in

dividends. However, governors of the FT may see such an adjustment as furthering the FT's service objectives through ensuring more cash remains with the FT. Unlike shareholders, they will not suffer a reduction in their wealth from asset write downs or a reduction in their income from lower dividends. Furthermore, the impairment does not affect the EBITDA (Earnings before interest, tax, depreciation and amortisation), the performance measure that Monitor has primarily used to assess FT performance against plans. Ellwood and Garcia-Lacalle (2012b) show impairments in 2009/10 were £2.5bn for all FTs (and £1bn in 2010/11). One FT impaired its new hospital by over £240m, resulting in negative equity and no dividend payments, but the accounting adjustment received no publicity in the local press. The impairment did not feature in the audit report from the Big4 firm that had audited the statements each year since the FT was formed in 2004 and limited its liability to £500,000. The governors have no direct *financial* link with the FT unlike shareholders who appoint the auditors of companies. They will not suffer any direct financial loss if the assets of the organisation are impaired or dividends reduced. FTs receive their funding from central government (via commissioning bodies) not through local charges or taxes. The auditors are appointed by governors and they report to governors stating their liability is only to the audited body.

“This report is made solely to the Board of governors of University Hospitals Birmingham NHS Foundation Trust (‘the Trust’) in accordance with Schedule 10 of the National Health Service Act 2006. Our audit work has been undertaken so that we might state to the Board of Governors of the Trust as a body, those matters we are required to state to them in an auditor’s report and for no other purpose. To the fullest extent permitted by law we do not accept or assume responsibility to anyone other than the Board of Governors of the Trust as a body, for our audit work for this report or for the opinions we have formed.”

(University Hospitals Birmingham FT, Annual Report and Accounts 2010/11, Extract from the Audit Report.)

There appears to be a missing level of audit and accountability – to the government and the wider tax payer providing the funds. This level is missing both in terms of the appointed auditors and the Secretary of State’s ‘armchair auditors’ who may pick up excessive expenses or remuneration, but are unlikely to question technical accounting adjustments of many millions of pounds, particularly if they have a beneficial financial effect on their local hospital. Not only has the army of armchair auditors failed to materialise but also the band of armchair accountants necessary to interpret the information.

Audit arrangements after the removal of the Audit Commission

In 2010, the Secretary of State for Local Government announced his intention to disband the Commission. Audit functions would move to the private sector within a framework overseen by the National Audit Office (NAO) and the accounting profession. The NAO would report to Parliament on the VFM and productivity of the sector.

The process to outsource the work of the Audit Commission's in-house audit practice (which covered 70% of the audits in local government and NHS trusts) commenced in September 2011 and, in March 2012, the award of five year audit contracts to four private firms starting from 2012/13 was announced. Two Big4 firms, KPMG LLP and Ernst & Young LLP, were awarded annual contracts of £23.1m and £20m respectively. The lion's share of the work, £41.3m, was awarded to Grant Thornton (UK) LLP, and the DA Partnership (formed by former Audit Commission staff but a wholly owned subsidiary of Mazars LLP) was awarded only £5m. These contracts were heralded as showing the extent of the Audit Commission's unique purchasing power and would contribute to an up to 40% cut in audit fees paid by local public bodies.

At first glance, such huge savings and the introduction of two new audit firms (Ernst & Young and DA Partnership) may seem testimony to the decision to remove the Audit Commission as an unnecessary expense, but it was the Audit Commission that oversaw the contracting process and exerted its power to achieve these savings – 'it is only a halfway house' (Parker, 2012). In the tendering process, the Audit Commission was a huge bulk purchaser of NHS and local government audits that could offer high volumes in return for lower unit costs. This power to achieve savings through bulk buying presumably disappears when the Commission goes. The scope of the audit has also been considerably reduced. The DA Partnership, comprising former Audit Commission practice staff was intended to operate as a mutual organisation, but with only one contract of £5m this is not a viable proposition and hence, it will operate as a wholly owned subsidiary of the second tier audit firm Mazars. Thus, there is likely to be considerable audit concentration in the future without the alternative of a public sector or mutual organisation alternative.

Implications for the future of audit in local public bodies

Our study of the audit arrangements for FTs gives an insight into what may arise for local public audit (local government and health) when an audit oversight body is disestablished. Greater concentration (as indicated above) without the Audit Commission and no specialist public sector auditor is likely to lead to an escalation of audit fees and other auditor remuneration. The independence of the auditor is reduced as the organisation appoints its auditor. There are fewer safeguards to audit independence and hence audit quality, the interests of governors may not necessarily align with the interests of central government (the major funder of the NHS and local government) or the taxpayer.

Professional oversight under the FRC, similar to the regime for company audits is planned (DCLG, 2012), this largely mirrors Monitor's arrangements for FTs. However, as Cooper and Robson (2006) observe, conglomerate accounting firms have become less the subject and more the site of professional regulation. Humphrey et al (2009) note how many decisions relating to how audits are conducted and audit firms are organised are made on a global basis by accounting firms and private standard setting bodies. The removal of

specialist auditors and the Audit Commission, even with an increased role for the NAO, may have significant implications for the nature and scope of local public audit.

Audit fees paid to private firms were higher than those paid to the Audit Commission's audit practice. Unlike the regime in the NHS trusts, where the Audit Commission had oversight, premiums were paid to some Big4 firms. Our study found premium payments to Deloitte and to a lesser extent PwC (neither of these two firms won tenders under the outsourcing of the Audit Commission's audit practice work in 2012), but analysis of FT auditors shows that, given the freedom to appoint their own auditors, FTs migrate to Big4 firms. Audit fee premiums are likely to increase when there is no benchmark public sector auditor and no collective oversight of fees. Thus, the envisaged savings in audit fees may not materialize in the future.

Further research is necessary to understand any changes in audit quality relating to the removal of the Audit Commission's monitoring of the work and the benchmark level of quality provided through its own audit practice. The FT market shows the incentives and scope for accounts manipulation that could be to the detriment of the tax payer and central government though not necessarily the recipients of audit reports. The substitution of a private sector audit model into local public audit without the financial interest of shareholders to press for audit quality leaves the general taxpayers' interest vulnerable.

We have focused on the regularity audit fee, but there are also consequences from the reduction in audit scope –VFM work is left more to the National Audit Office, audit inspection and assessment are removed, as is other work such as the data assurance programme for the NHS Payment by Results (tariff system). The reduction in scope of the audit function will have direct cost savings (though perhaps not as high as announced if the public sector bodies purchase the services excluded from the contracts separately) and there may be costly indirect consequences. There has been no evaluation of the effect on performance of removing the Audit Commission's assessment regime. Further research is needed on this issue.

Conclusions

Audit quality including audit independence is an important aspect of public accountability in a democratic society. An audit oversight body for local public audit can improve audit independence through control of auditor appointment processes, fees and other payments. This reduces the scope for 'cosiness' between auditors and their auditees and was a fundamental principle set out in Lord Sharman's review of UK public audit. The provision of specialist auditors, the monitoring of audits and provision of a forum for discussion of public service all enhance audit quality. Within the FT sector, where the Audit Commission has never appointed auditors, the audit arrangements allow premiums to be paid to Big 4 firms and for the firms to limit their liability. Audit fee payments to private firms exceeded those paid for regularity work to the specialist audit practice of the Audit Commission. There are indications that manipulation of accounting statements can occur in local public

bodies which may be against the taxpayers' interest, but not necessarily against those who appoint the auditor and to whom they report. The private sector audit model jeopardises auditor independence and leaves the taxpayer vulnerable particularly without further safeguards against cosy relationships between auditors and their client.

The outsourcing of the Commission's audit practice work in health and local government in 2012 achieves considerable savings in audit fees through a bulk tendering process by the Audit Commission. However, we are not led to conclude that an oversight board is an unnecessary expense. Our findings show it had an important role in the price and quality of audit. Following the Audit Commission's abolition, it is likely that fees will rise when individual local public bodies appoint their auditor, particularly Big4 auditors. The absence of a public sector alternative or benchmark will lead to higher fees. The new arrangements reduce audit independence and may significantly reduce audit quality. There may be savings on performance assessment, VFM and inspection, but much further research is needed to assess the indirect costs associated with the change in scope and nature of local public audit. The findings in this study, show private firms to be more expensive and the substitution of a private sector (shareholder) model of audit appointment and reporting reduces independence and the assurance of audit quality in local public audit. The abolition of a specialist oversight body reduces protection for the public purse.

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ⁱ The Code of Recommended Practice for Local Authorities on Data Transparency 2011 stipulates several recommended minimum disclosures e.g. 'expenditure over £500 (including costs, supplier and transaction information)'. The information is made available through open government licence <http://www.nationalarchives.gov.uk/doc/open-government-licence>

ⁱⁱ Section 8 of the Audit Commission Act 1998.

ⁱⁱⁱ The 1972 Local Government Act allowed local authorities to choose their own auditors –either District Audit or a private firm of auditors. However, the 1976 Layfield Committee review of local government finance concluded that it was wrong for any public body to be able to choose its own auditors. Nevertheless, the situation remained until the 1982 Local Government Finance Act established the Audit Commission.

^{iv} In the UK, local government was exclusively audited by the District Audit Service for 130 years until the Local Government Act 1972.

^v 'District Audit' did not exist as a separate agency of the Commission throughout the Commission's life. We use 'audit practice' for the Commission's in house auditors.

^{vi} The Audit firms undertaking more than ten audits of companies of major public interest are subject to inspections which include a review of their policies and procedures supporting audit quality. The largest four firms are subject to inspection on an annual basis and other major firms on an extended cycle of up to three years. Prior to 1 April 2013 the reviews of policies and procedures of those firms with ten or fewer 'major' audit clients were delegated to the professional bodies with which they were registered for audit purposes e.g. ICAEW. From 1 April 2013 the inspections of these firms are delegated in full to the professional bodies such as ICAEW.

^{vii} Based on the auditor remuneration for 121 NHS trusts as shown in the NHS (England) Summarised Accounts 2009-2010 (HC410).